

# Building a family office to steward family wealth and values



Advanced Planning Group  
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# Centers of excellence

**Family Office Solutions** is a team of specialists that exclusively works with USD 100 million+ net worth families and family offices. The team helps clients navigate the challenges and opportunities across their family enterprises, including their businesses, family offices, philanthropic structures, and passions and interests. Having this expertise under one roof allows for integration and layering of services across the UBS ecosystem, delivering a personalized, holistic client experience.

Within Family Office Solutions sits our **Family Office Design and Governance** practice. This team facilitates discussions with clients about family office structure. It serves as a thought partner for families considering options for managing their family's wealth and resources, and for families with an existing family office. It advises families across North America on family office organizational design, structure and governance, as well as operational best practices and strategy to manage and sustain their wealth for future generations.

**The Advanced Planning Group** consists of former practicing estate planning and tax attorneys with extensive private practice experience and diverse areas of specialization, including estate planning strategies, income and transfer tax planning, family office structuring, business succession planning, charitable planning, and family governance. The Advanced Planning Group provides comprehensive planning and sophisticated advice and education to UHNW clients of the firm. The Advanced Planning Group also serves as a think tank for the firm, providing thought leadership and creating a robust intellectual capital library on estate planning, tax, and related topics of interest to UHNW families.

An additional resource for UBS clients and prospects is our **Family Office Compass**, which is intended to be a practical guide for families setting up their own dedicated family office. The Compass takes you through a structured process and prompts your thinking about your family's needs and how your family office should be set up to meet these needs. You will also find examples of how other families have designed their family offices. Please reach out to your Financial Advisor to request a copy.



# Dear reader,

There is a saying that goes, “If you have seen one family office, you have seen one family office.” Family offices are as different as the families they serve—one size does not fit all. For families who are seeking to coordinate and consolidate their investment management and planning, a well-structured family office can play a crucial role in the preservation and growth of wealth through the generations.

Just as every family is different, so too is what’s required of every family office. Since business families established the first family offices in the early 20th century, their number has steadily increased, with the first decades of the 21st century seeing the most rapid growth. As they have multiplied, family offices have taken different forms, depending on a family’s needs.

At UBS, we partner with families across the world, helping them establish and manage family offices suited to their goals and circumstances. We offer you the benefit of our expertise in structure and governance, as well as operational best practices and strategy for managing and sustaining wealth across generations.

We have written this paper to guide you through some of the issues faced by family offices. After all, good planning has timeless benefits. Indeed, some of those original family offices formed over 100 years ago are still presiding over the founders’ legacies, continuing to serve their families well as they adapt to changing circumstances.

Regards,



Ann Bjerke



Brian Hans



David Leibell

# Executive summary

A family office safeguards a family's wealth and values across generations. It implements investment, wealth planning and philanthropic strategies designed to achieve the family's long-term goals. Depending on the family's objectives and wealth, the size and structure of each family office will differ.

Most family offices evolve to suit a family's changing needs, starting within a family business and then becoming a stand-alone organization. The funding, legal entity, ownership and activities of a family office all have implications that require thoughtful consideration.

A family's businesses, wealth and needs evolve over time. Revisiting the family office's management and structures ensures that it adapts to those changing needs. A successful family office not only preserves wealth but also helps to achieve philanthropic objectives and preserve family values.

# What is a family office?

Families create family offices to manage their wealth while nurturing their identity and values. They look after a range of areas from wealth management to wealth transfer, philanthropy and family governance.



# Definition of a family office

The Family Office Exchange (FOX), a membership organization of family offices, defines a family office as “a unique family business that is created to provide tailored wealth management solutions in an integrated fashion while promoting and preserving the identity and values of the family.”<sup>1</sup> The family office acts as the quarterback for the stewardship of the family wealth, coordinating with the family’s outside professional advisors and creating and implementing strategies

connected to the family’s wealth objectives. Typical family office services include providing directly or coordinating with outside professional services such as tax, investment management, wealth transfer (including estate and philanthropic planning), risk management, family governance and financial education and development of the talent of family members. In addition, the best family offices have a higher purpose, which is “to bridge generations to create continuity and

cohesion for families around their wealth.”<sup>2</sup> In its ideal form, the family office helps steward family wealth by supporting the following four dimensions of the family:

1. Business legacy
2. Financial legacy
3. Family legacy
4. Philanthropic legacy<sup>3</sup>

<sup>1</sup> Family Office Exchange, *Fox Guide to the Professional Family Office* (2014), at p. 3.

<sup>2</sup> Kirby Rosplock, *The Complete Family Office Handbook: A Guide for Affluent Families and the Advisors Who Serve Them* (2014) at p. 1.

<sup>3</sup> *Ibid.*, at p. 9.

## History of family offices

In the US, the early family offices were established by business-owning families that made their wealth during the Industrial Revolution. One of the first family offices was established in 1882 by John D. Rockefeller Sr. as a mechanism for centralizing the family’s wealth and philanthropy. Numerous other business-owning families of great wealth followed Rockefeller’s lead, such as the Mellon, DuPont and Phipps families.

The growth of family offices connected to family business continues today. A recent study found that almost four fifths of family offices (79%) still have operating businesses.<sup>4</sup> Because these entities are private and emphasize confidentiality, it’s difficult to get a true number of the family offices currently in existence in the US. It’s estimated that there are more than 3,000 single family offices (SFOs), and at least twice that number embedded within private operating companies (primarily family businesses).<sup>5</sup>

<sup>4</sup> Global Family Office Survey, 2023.

<sup>5</sup> The UBS/Campden Wealth Global Family Office Survey, 2019.

# Scope of family office services

Understanding the services a family office oversees or provides directly gives a strong indication of how it operates in relation to a wealthy family. There are six basic categories of services that family offices typically provide:

**1. Strategic wealth management:**

This involves long-term strategic planning for accomplishing family wealth objectives for current and future generations. In addition to determining goals, strategic wealth management includes building the family's governance structures, including family boards and councils, as well as family mission statements and constitutions.

**2. Investment planning:**

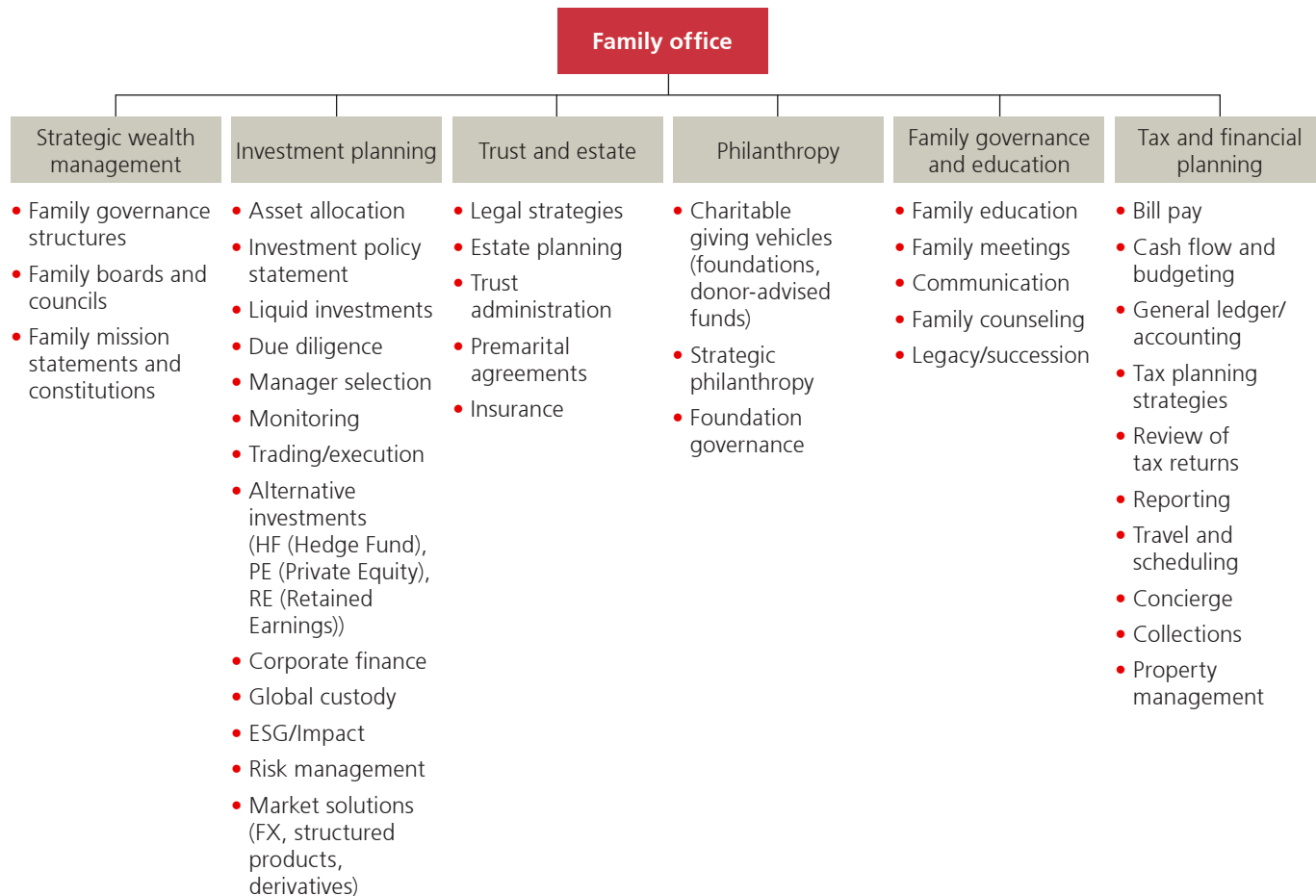
Whether investments are handled in-house or outsourced, proper investment oversight—including asset allocation, portfolio construction, creation of investment policy statements, manager selection and due diligence—is at the core of family office functions. Also included in this category are investment recordkeeping and reporting (including consolidated reporting).

**3. Trusts and estates:** This service involves overseeing the structure and execution of the legal documents necessary for efficient wealth transfer. The family office is also the keeper of these documents, often overseeing their administration and working with those serving in any fiduciary role. Many wealthy families choose to establish a private family trust company under the laws of a trust and tax-friendly state (e.g., South Dakota, Nevada or New Hampshire) to act as trustee of the various family trusts. In fact, in some circumstances, the private family trust company can act as the family office or the family office can be an affiliate of the private family trust company.



**Family education involves teaching each generation of the family necessary skills to ensure they will be effective shareholders, directors and managers.**

Figure 1. **What can a family office do?**



**4. Philanthropy:** This service includes developing strategies for helping the family be effective in its charitable giving. Creation and oversight of the family's giving vehicles, such as family foundations and donor-advised funds, are also a component of family office philanthropic services. Involving the rising generations in the family's philanthropic initiatives can be an effective way of transferring values and engaging younger family members in the overall family governance structure.

**5. Family governance and education:** Once family governance structures are in place, the family office coordinates the necessary meetings and communications to make sure such governance structures are working effectively. Family education involves teaching each generation of the family necessary skills to ensure they will be effective shareholders, directors and managers of the various family governance structures and businesses.

**6. Tax and financial planning:** Tax planning includes the oversight of personal and business tax returns. Financial planning includes cash flow management and budgeting for individual family members along with bill pay and concierge services such as management of family real estate and art.

**Source:** UBS Family Office Solutions Group, Feb. 2020.

# Types of family offices



Family offices are as unique as the families they serve. They should be structured in a manner that best represents the particular needs of the family. When a wealthy family is considering a family office, there's a steep learning curve. Numerous for-profit entities provide family office services. These include private banks, private wealth divisions of large brokerage firms, registered investment advisors, accounting firms, private client law firms and consultants. All have their place in the structure and execution of family office services, but the family first needs to consider the type of family office it will create or participate in. These include:

**Some family offices have tremendous in-house expertise, operating closely held businesses, and decide to use that expertise to make direct investments.**

**Single family office (SFO):** An entity that manages the financial and personal affairs of one wealthy family. Such an entity typically has several staff members including a chief executive officer, chief investment officer, staff accountants, bookkeepers and employees handling family real estate, art, and family education and governance. Complicated tax planning, certain investment classes (for example, hedge funds and private equity) and wealth transfer planning are typically outsourced. Some family offices, however, particularly those affiliated with family businesses, have tremendous in-house expertise operating closely held businesses, and decide to use that expertise to make direct investments in these types of entities. There can be a dedicated family office location, separate from the family business, with little or no crossover staffing and its own tech infrastructure for privacy and confidentiality purposes.

**Virtual/coordinating family office (VFO):** A VFO outsources most if not all activities, gaining access to people, products and services when needed. It typically employs one or two people to handle day-to-day operations and coordinate outside advisors and outsourced services. It's usually headed by a senior family member, the family business chief financial officer or a trusted professional, such as a CPA or attorney. Many private banks and private wealth divisions of large brokerage firms have set up specialized departments to provide these entities with full service around investing, along with specialty advice in wealth transfer, succession planning, philanthropy, family education and family governance.

**Family-owned multi-family office (MFO):** A company that manages the wealth of a group of wealthy families. It's usually owned by one or more of the founding families. The idea is to reduce the overall cost of services when compared to a full-fledged single family office.

**Commercial MFO:** Typically a boutique investment firm owned by a third party that provides investment and certain other ancillary services to wealthy families. These businesses range from pure investment shops to those that provide a full range of family office services.



# Evolution of the single family office

Most family offices begin within the family business before evolving into dedicated entities. Structuring family offices takes careful planning, including legal and tax considerations.





Since the majority of family offices evolve from a family business or the sale of a family business, understanding the evolution of such entities helps put the spectrum of family offices in context. Most family businesses, no matter what the asset level, provide family office-type services to owners and their family members. It isn't uncommon for a family business to also be called the family bank. The formalization of these services into a family office structure depends on several factors, including:

- 1) the size of family wealth;
- 2) the current generation of the family business (i.e., a family office serving the founder and their descendants or a family office serving third, fourth and fifth generations);
- 3) the size and complexity of the family;
- 4) cost; and
- 5) the willingness of family members to work together on their personal financial matters. The stages of family office evolution when connected to the family business are typically.

**Embedded family office:** An embedded family office provides services to family members within the family business. There are typically no separate employees. Services are provided by family business employees, specifically long-tenured, trusted employees. Most services are outsourced under the oversight of a family member or trusted employee. This type of structure can work well for smaller families in the founder or sibling generations or families with total wealth less than \$250 million, when hiring dedicated employees may be unwarranted or cost-prohibitive. There are several downsides to this type of structure. First, family business employees may not be particularly skilled in providing oversight of family office services such as investments, wealth transfer and family governance. Second, these employees may favor family members active in the business to the detriment of inactive family members. Third, these entities tend to have less confidentiality and privacy for family members. Fourth, the employees often have other duties, so there is a competition between business-related duties and family office-related duties. If there's a major transaction, an employee may be distracted from handling important but perhaps less urgent

family matters (e.g., estate tax planning). Finally, if the family decides to sell the business or bring in outside investors, it will need to address those "personal" expenses that the business has been covering.

**Separate VFO:** Sometimes motivated by the scale of family wealth or the increasing number of family members, with a separate VFO, family office services are moved out of the family business to a dedicated entity that only handles family office services. While most services continue to be outsourced, management is professionalized and dedicated specifically to the family office. These types of entities work well with families with total net worth of \$250 million to \$1 billion.

**SFO:** Once a business-owning family crosses the billion-dollar mark, things tend to change. More of the administrative services are brought in-house. In addition, SFOs typically have a chief investment officer who may invest in many asset classes in-house. The SFO tends to have the greatest internal costs, but these can be offset by the fact that investment fees to outside providers are reduced by in-house management and economies of scale due to the size of assets under management.

# Structuring a single family office

If a family determines that a single family office is the best approach for coordinating and centralizing the management of the family wealth, it is important to follow a methodical process in order to help ensure the delivery of the scope of services needed by the family, achieve the desired legal and tax results, and establish a governance structure that will serve the family over multiple generations.

**Mission and strategy.** A family office mission may include:

- 1) preservation and regeneration of family wealth;
- 2) a coordinated approach to decision-making;
- 3) development of family talent and entrepreneurship;
- 4) support of family unity; and
- 5) strategic philanthropy.

While the mission of the family office may be initially determined by the senior generation establishing the family office, it will likely evolve over time as rising generations become involved in decision-making and governance.

Once the initial mission of the family office is clear, strategies to achieve the goals are easier to evaluate. A crucial element of strategic planning for a family office is to align the goals of the family with the goals of the family business (if there is one), the family office and family philanthropy.

Family decision-makers and stakeholders should consider holding several meetings at the outset to ensure that opinions, concerns and ideas are raised, debated and resolved. Communication on topics like involvement of spouses, investment philosophy, employment opportunities for family members at the family office and processes for making hiring decisions can be important at the outset to ensure the family is on the same page. The strategy is not stagnant: It should be reviewed and revised every few years and upon the occurrence of significant changes in family circumstances.

**Business plan.** Once the mission and strategy are in place, the next step is a business plan. Creating an effective business plan for the design of a family office requires putting together a team, including family members, trusted advisors and, under some circumstances, a family office consultant. Mapping out the current situation is a good place to start. Who currently advises and supports the family? What is working and where are the gaps? Are the existing tax and

legal advisors sufficient or should new advisor partnerships be established? This will help the team determine the role the family office will play. It will also help determine which services should be handled directly by the family office and which should be outsourced. The business plan should also address governance, legal structures, staffing, tax, accounting, IT, etc. One mantra the team should remember during the business planning process is: "Don't overbuild."

It is important to understand the upfront legal, tax and accounting costs to establish and maintain a single family office. A recent UBS Global Family Office survey estimated that the average cost of running a family office in 2022 is 42.2 basis points (bps) of assets under management, that varies depending on the size of assets. In a family office with assets of USD 100 million to USD 250 million, this cost is 58.6 bps. When assets rise to USD 251 million to USD 1.0 billion, though, the cost falls to 42.5 bps. And, for large offices managing assets of USD 1.01 billion or more, average costs fall to 31.7 bps.<sup>6</sup>

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<sup>6</sup> UBS 2022 Global Family Office Report.

# Legal and tax considerations for structuring a single family office

The legal structure of the SFO may generate tax benefits for the family. As a result of recent tax law changes and legal developments, many families are revisiting the structure of their family office in order to avail themselves of the ability to deduct investment management fees for income tax purposes.

## Background

Historically, expenses incurred for the production of income or the management or conservation of property held for the production of income (e.g., investment advisory fees) were deductible under §212 of the Internal Revenue Code (the Code) to the extent those expenses (together with other miscellaneous itemized deductions) exceeded 2% of adjusted gross income for a given tax year. However, the passage of the Tax Cuts and Jobs Act of 2017 (the 2017 Act) changed these rules.

Code §67(g) was added by the 2017 Act, which suspended the deduction of miscellaneous itemized deductions subject to the 2% floor for tax years 2018 through 2025. As a result, unless a deduction for these expenses is available under another section of the Code, certain individuals and

entities, including family offices, engaged in investment management may no longer be able to deduct these expenses.

Under Code §162, expenses incurred in an investment management business are fully deductible. The 2017 Act's elimination of miscellaneous itemized deductions (including those under Code §212) did not impact the ability to deduct expenses under Code §162 for expenses incurred in an investment management "trade or business." Therefore, an investment management enterprise that is recognized as a trade or business can still deduct investment management expenses.

Regarding what constitutes an investment management trade or business, courts have historically

imposed strict standards for determining whether investment management and related activities constitute a trade or business. Investing one's own assets does not rise to the level of a trade or business.

Some of the relevant factors that courts have considered are whether the enterprise has a full-time staff, if the nature of the services provided are commensurate with those provided by investment managers in the marketplace, whether the investment manager receives compensation and the type of compensation received, and whether the owners of the service provider and the "client" are the same.



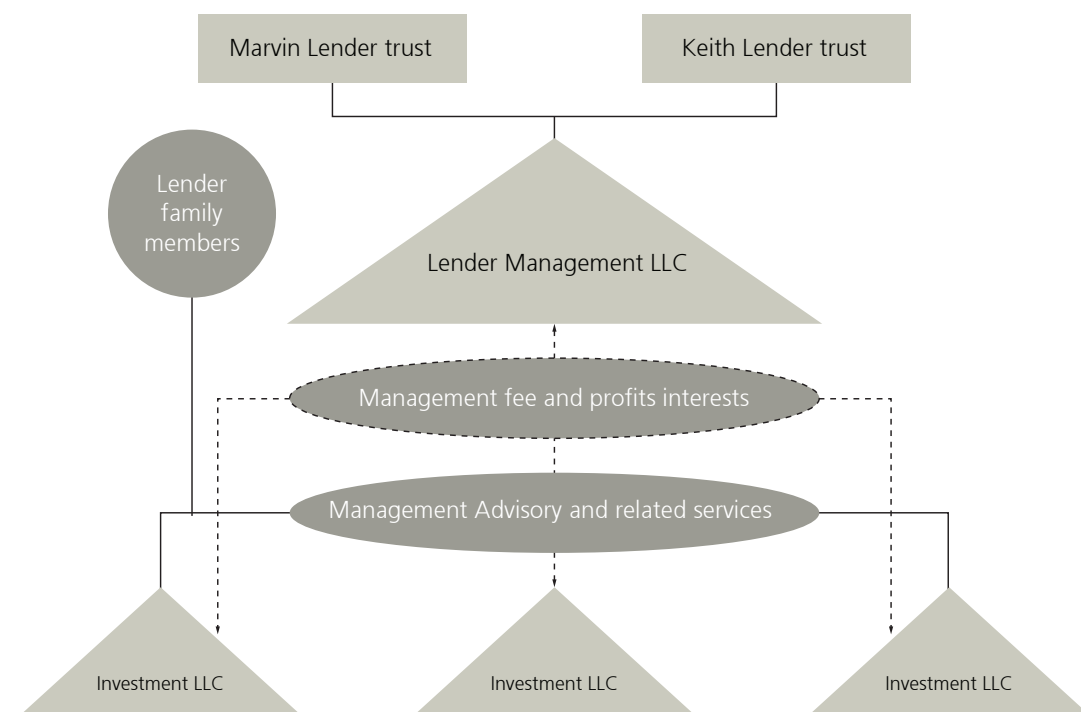
# Recent case law:

## *Lender and Hellmann*

The US Tax Court has addressed the question of whether an investment management activity rises to the level of a trade or business in two recent cases. The first case is *Lender Management LLC v. Commissioner of Internal Revenue*, T.C. Memo. 2017-246 (2017). In the *Lender* case, the Lender family (who founded Lender's Bagels) established an investment management arm of its family office in the structure shown in Figure 2.

(continued)

Figure 2. **Structure of Lender Management LLC**



**Source:** UBS Advanced Planning Group, Feb. 2020. UBS Financial Services Inc., its affiliates and its employees are not in the business of providing tax or legal advice. Clients should seek advice based on their particular circumstances from an independent tax or legal advisor. This source is the court's opinion.

## Recent case law: *Lender* and *Hellmann* (continued)

### *Continued from preceding page*

Lender Management LLC served as the investment management company and it provided investment management services to the three Investment LLCs. The Investment LLCs were owned by various Lender family members. The two Lender family members who owned Lender Management LLC also held minority interests in the Investment LLCs. In order to facilitate investment management and diversification for Lender family members, the three Investment LLCs were established. Each LLC invested in a different asset class, one invested in private equity, another in hedge funds and the last held publicly traded securities.

In exchange for acting as sole investment manager for each of the three Investment LLCs, similar to what would be seen in a private equity or hedge fund, Lender Management received a profits interest as well as a management fee from the Investment LLCs. Lender Management LLC deducted expenses related to salaries and wages for its staff, repairs and maintenance, rent, taxes and licenses, depreciation, employee

benefits programs and other expenses involved in running the operations of the entity.

The Tax Court held that Lender Management LLC was engaged in a trade or business and that its expenses were deductible under §162 of the Code. The court identified the following specific factors as being significant in its determination that Lender Management LLC was engaged in a trade or business; (i) Lender Management LLC's compensation structure was similar to that of a private equity or hedge fund manager as opposed to just representing returns of a passive investor because of the profits interest for its services in addition to its management fee; (ii) the difference in ownership of Lender Management LLC and the Investment LLCs; and (iii) the fact that Lender Management LLC had full-time employees and substantial operations in managing the investments of the Investment LLCs.

The second recent case regarding investment management trades is *Hellmann v. Commissioner of Internal Revenue*, Tax Court Order,

**Those family offices and others engaged in the investment management activities may enjoy material tax savings by following the structure and rationale set forth by the Tax Court in the *Lender* and *Hellmann* cases.**

Docket No. 8486-17, filed October 1, 2018. The *Hellmann* case was settled by the taxpayers and the Internal Revenue Service prior to a decision from the Tax Court after the initial court proceedings. However, the Tax Court issued an order in the case, denying the taxpayer's request for a ruling that the facts of the case were so similar to the *Lender* case that a trial was unnecessary and the taxpayer should prevail as a matter of law. In the order, the Tax Court discussed the *Lender* case and contrasted the facts of the *Lender* case with the facts of the *Hellmann* case.

The Tax Court noted that the structure in *Hellmann* lacked the disproportionality of ownership as between the management company and the assets being managed that was present in the *Lender* case. In the *Hellmann* case, the same four family members who owned the management company also owned the assets being managed in the same proportions. In addition, the Tax Court highlighted that the family members in the *Lender* case were more akin to independent clients than in the *Hellmann* case because in

*Lender* some of the family members were geographically dispersed, did not know each other, and had very different investment goals and objectives.

In the Order, the Tax Court in *Hellmann* reiterated the importance of the following factors in the analysis of whether an investment management enterprise constitutes a trade or business:

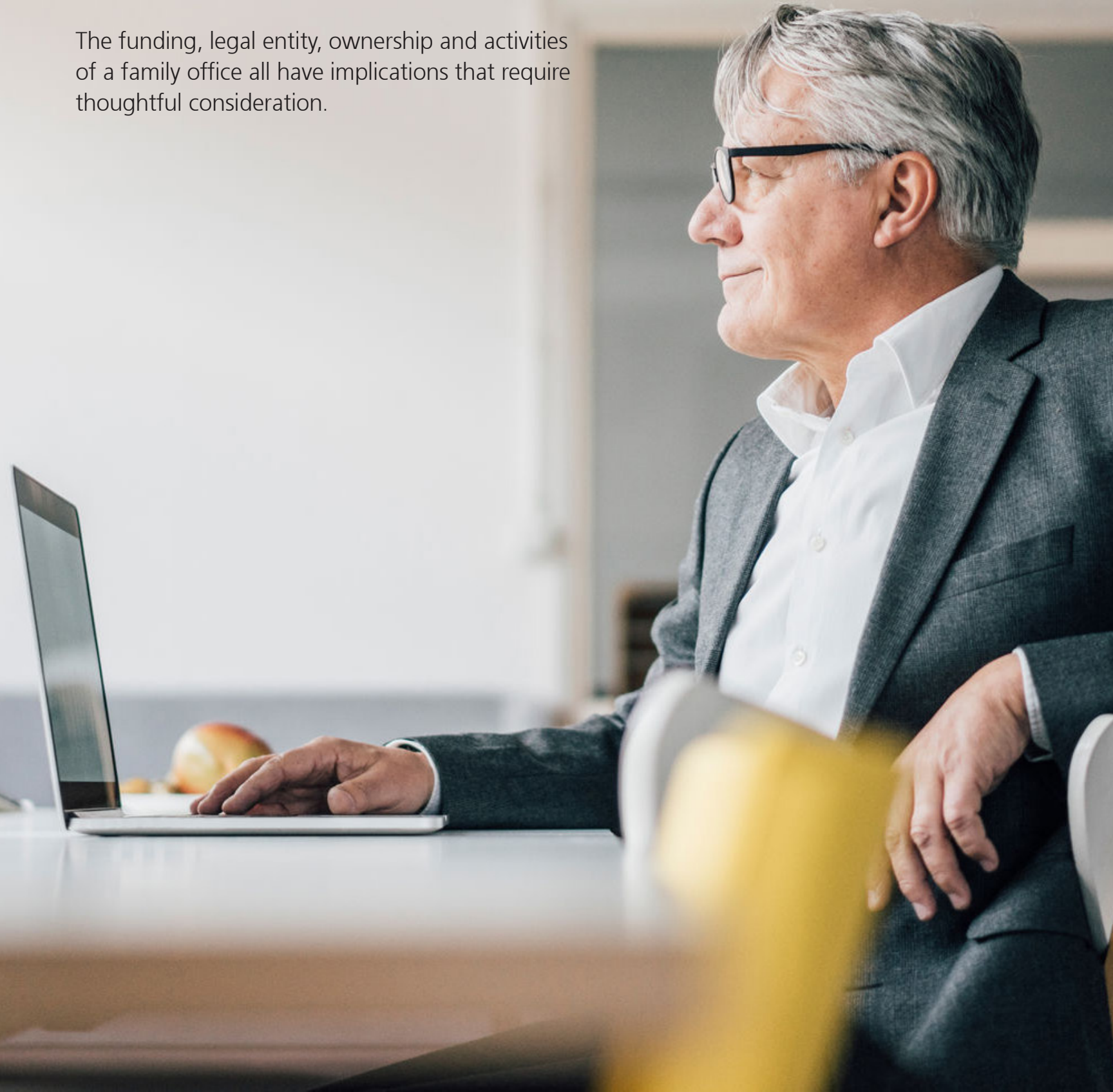
1. The nature and extent of the services provided by the employees of the family office;
2. The expertise of and the time spent by the family office employees as compared with outside investment managers and consultants;
3. The differentiation of investment strategies for different family members based on individual investment desires and needs; and
4. The proportionality between the share of profits indirectly flowing to each family member through their share of ownership of the family office relative to that same family member's ownership of the managed funds.

If otherwise in line with the family's objectives, those family offices and others engaged in investment management activities may be able to deduct expenses (including third-party management and related fees) by following the structure and rationale set forth by the Tax Court in the *Lender* and *Hellmann* cases. Specifically, the management company should:

1. Be owned by different family members or in different percentages relative to the owners of the investment LLCs or "clients;"
2. Receive a profits interest and a management fee for its compensation;
3. Provide extensive services rather than only administrative or "back office" services; and
4. Have full-time employees.

# Funding the family office

The funding, legal entity, ownership and activities of a family office all have implications that require thoughtful consideration.

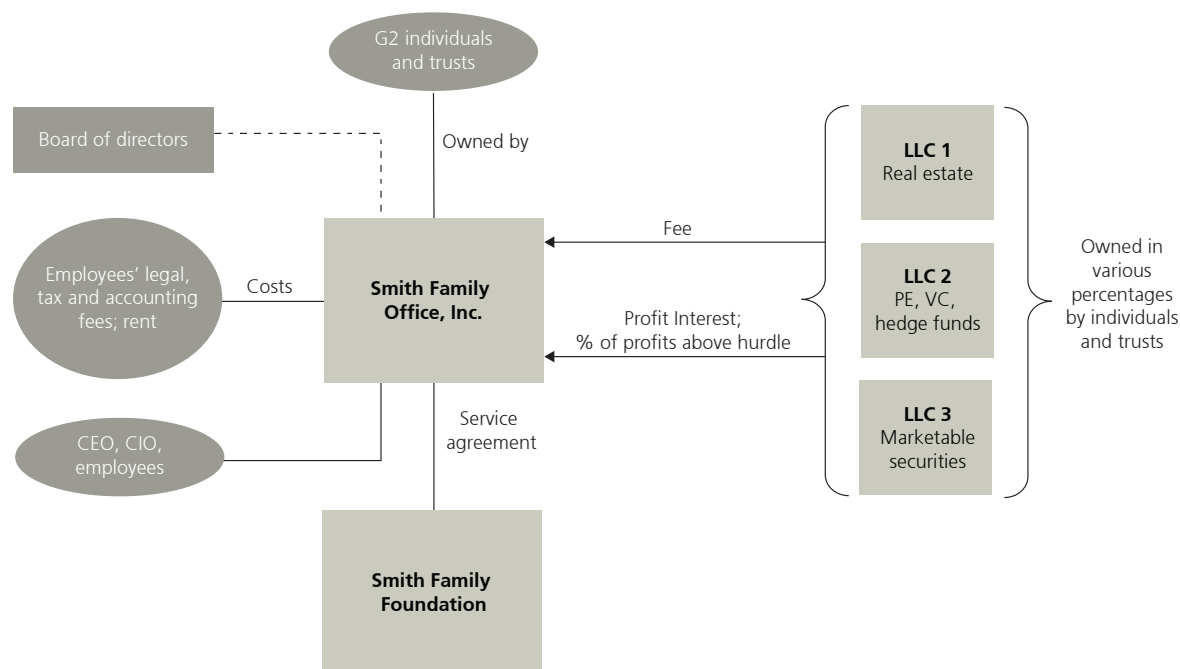




Many family offices fund their operations and expenses through a profits interest structure as was present in the *Lender* case. The favorable tax treatment and ability to deduct investment advisory fees and other professional fees is possible only if the family office assumes meaningful economic risk. In the chart below, the Smith Family Office would receive a management fee and economic return through a

profits interest, or carried interest, meaning that the family office only receives cash to cover expenses if the investment LLCs are profitable. If, in any given year, the cash received due to the profits interest is insufficient to cover expenses, the Smith Family Office, or its owners, would be liable for the balance of the expenses. This structure substantiates the position that the family office is a bona fide trade or business.

Figure 3. **Smith Family Office structure**



**Source:** UBS Advanced Planning Group, Feb. 2020. UBS Financial Services Inc., its affiliates and its employees are not in the business of providing tax or legal advice. Clients should seek advice based on their particular circumstances from an independent tax or legal advisor.

# Choice of entity



An additional element of the strategy that might be considered is using a C corporation (or making an election to have the entity treated as a C corporation for income tax purposes) as the management company. A C corporation is entitled to a presumption under the tax law that it is engaged in a trade or business and, therefore, should be entitled to deduct its ordinary and necessary expenses incurred in connection with the trade or business. From a tax standpoint, this may strengthen the argument that the management company is engaged in a trade or business. However, the presumption under the tax law that a C corporation is engaged in a trade or business is rebuttable. In other words, simply incorporating an enterprise that would not otherwise pass muster as an investment management trade or business will not carry the day, but it may be used by a management company as a positive factor tending to show that it is engaged in a bona fide trade or business activity.

However, when considering C corporations it is important to pay special attention to other, less desirable tax consequences that might arise. Two such considerations are the personal holding company tax rules and the accumulated earnings tax rules.

The determination as to whether a corporation is a personal holding company and, if so, if it is subject to the personal holding company tax is an analysis subject to many nuances and exceptions. In general terms, a personal holding company is a corporation (i) that receives predominantly income from passive sources (interest, dividends, rents, etc.) and (ii) of which five or fewer individuals own, directly or indirectly, more than 50% of the value of the stock. In addition to their regular corporate income tax liability, personal holding companies are subject to an additional corporate level tax on their personal holding company income (a defined term). As such, many family

**Analyzing whether a corporation is a personal holding company and, if so, if it is subject to the personal holding company tax is subject to many nuances and exceptions.**

office investment management companies will fall within the definition of a personal holding company and thus should consider the application of the personal holding company tax rules.

The accumulated earnings tax is another additional corporate-level tax imposed on corporations that retain earnings in excess of what is necessary to meet the reasonable needs of the business. Without the accumulated earnings tax, corporations would be able to avoid having their shareholders pay tax on dividends from the corporation by retaining the cash within the corporation. As a result, unless the corporation can show that retained earnings are intended to meet the reasonably anticipated needs of the business, the accumulated earnings tax may apply. Given the reduction in the corporate tax rate that came as a result of the 2017 Act, the Internal Revenue Service (IRS) is more likely to focus on corporations seeking to avoid issuing dividends

that may be subject to higher individual federal income tax rates by retaining the funds in corporate solution. Accordingly, family offices that structure their investment management companies as C corporations should consider the potential application of the accumulated earnings tax.

In addition to the tax issues, there's an often overlooked privacy issue. For purposes of diversity jurisdiction in federal court, the court looks through any entity other than a corporation. If a family office is organized as a limited liability company, this potentially can expose the family's wealth structure (or at least a part of it) to the public.

If the family office doesn't hold any underlying investments, then this isn't an issue. In many cases, a family's investments are held through trusts, LLCs or other entities, and the family office is only providing management and other services to those entities.

If, however, the family office acts as a holding company, then this is an issue. If, for example, the family office owns an interest in a commercial office building through one or more limited liability companies and there's litigation against the owner of the real estate, the court would look through the LLCs and the family office for purposes of determining diversity. If the family owns the family office through one or more trusts, that structure will become a part of the court's records.

The parties to the litigation can seek a protective order barring the disclosure of that information, and a court often will grant it. However, it's unlikely that, if a third party—such as a media outlet—challenged the order, the order would survive scrutiny.

The importance of this issue varies from family to family. Some families aren't concerned about the potential exposure. Other families are more protective of their privacy.

# Ownership of management company

Income tax considerations are critical when considering the ownership of the management company (i.e., Smith Family Office), and for those reasons, it may not be advisable for the management company to be owned by Generation 1. However, transitioning ownership of the management company to younger generations may result in gift and estate tax consequences. If the management company is funded through a profits interest, a proper valuation of the carried interest should be obtained.

Due to the intra-family nature of the family office structure, if the carried interest is undervalued or overvalued relative to what the value would be in the commercial market, a taxable gift could result. Furthermore, the carried interest should be carefully analyzed regarding whether it would be considered an interest to which §2701 of the Code applies. If §2701 of the Code applies to the carried interest, an unintended gift might result.



# Securities law considerations

Family office management and advisors will need to be familiar with the federal and state securities laws which can affect their operations. Because a family office will generally provide advice relating to the family's investments in securities, it will be subject to regulation and registration requirements under the Investment Advisers Act of 1940 unless it falls within an exemption. The Dodd-Frank Act created a rule in 2011 which provides an exemption for family offices from regulation and registration as an "investment advisor" if they meet certain requirements.<sup>7</sup>

The "Family Office Rule" contains complex definitions and requirements that family offices need to examine closely in light of their particular facts and circumstances. Generally, to be considered a family office that qualifies for the exclusion, it must provide investment advice only to "family clients," be wholly owned and controlled by family clients and cannot hold itself out to the public as an investment advisor.

The definition of "family client" is complex and important to understand. It covers certain family members, certain trusts and entities operated for family clients, key employees of the family office and certain family-funded charitable organizations. Family members include all lineal descendants of a common ancestor (up to 10 generations removed) and spouses or spousal equivalents of those descendants. The family member definition includes individuals adopted, stepchildren, foster children and former family members (e.g., divorced family members). Note that the definition does not include in-laws. Accordingly, if a family office provides investment advice to the mother-in-law of a family member, for example, it may lose the ability to claim the exemption from regulation under the Advisers Act. The family office may be able to request a "no-action" letter from the SEC on this issue.

The inclusion of "key employees" under the definition of family client creates the ability for a family office

to offer investment opportunities to key talent as means to create an attractive compensation package. The definition of "key employees" includes an employee of the family office (or an affiliated family office, also a defined term) who is an executive officer, director, trustee, general partner or any other employee, other than a clerical or secretarial employee, who has participated in the investment activities of the family office for at least 12 months. Former key employees are also recognized as key employees, such that a former CEO, for example, can maintain their investments with the family office but cannot make additional new investments after they no longer work at the family office.

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<sup>7</sup> Rule 202(a)(11)(G)-1 under the Investment Advisers Act of 1940.

# Staffing the family office

Proper staffing is crucial to the success of a family office. Family offices often begin by transitioning a key administrative employee from an operating company to a full-time employee for certain family members and evolve to a larger staff. Key roles include a Chief Executive Officer, Chief Investment Officer and Chief Operating Officer and often require in-house legal counsel, compliance officers, trust officers and foundation personnel. As the size of


the staff increases, the family should be thoughtful about providing employment opportunities to family members and how that may impact the dynamic and performance of the family office. They may want to consider creating employment policies that set forth the requirements and credentials necessary to work in the family and create guidelines for resolving conflict in a system where a family member employee may also be a client.

## Compensation of family office employees

Recruiting and retaining key employees for family office leadership roles often requires creative incentive-based compensation. Many family offices allow certain key employees to co-invest in direct investments (and may make loans to employees to facilitate the investment) and participate in a carried interest in order to share in the profits of investment ventures at a lower capital gains tax rate. It is also possible for a family office to create a plan that grants performance shares, units or cash that vest over time or after attaining certain goals.

When designing compensation packages, family offices should consider whether the incentive compensation programs are aligned with the family's goals and balance the potential longer-term investment strategy of the family with the shorter-term liquidity needs of the employees. As these plans can become very complex, it is important to carefully structure and implement an appropriate and tax-efficient compensation structure.

# Conclusion

A photograph of two women sitting on a rug in a modern living room, laughing together. The woman on the left is older with short grey hair, wearing a dark blue cardigan over a white top and tan pants. The woman on the right is younger with long brown hair, wearing a white blouse under a tan cardigan and dark pants. They are both smiling and looking towards the right. In the background, there is a brown sofa with a light-colored throw blanket, a large window, and a dining area with a table and chairs.

As a family's businesses, wealth and needs evolve over time, the family should revisit the management and structures in place that serve and implement their vision. With strong commitment and governance, a family office, in its many forms and iterations, can provide a family with investment, organizational, legal and tax benefits.

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